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External debt sustainability and development

Report of the Secretary-General

Summary

The present report, submitted pursuant to General Assembly resolution 66/189, reviews recent developments in the external debt of developing countries with a special focus on the role of credit rating agencies and on the problems relating to the design of a structured mechanism for dealing with sovereign debt restructuring.

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I. Introduction

1. The present report is submitted in accordance with paragraph 36 of General Assembly resolution 66/189. It includes a comprehensive analysis of the external debt situation and debt-servicing problems faced by developing countries and transition economies. It describes new developments and trends in external debt and related areas of development finance, discusses various issues relating to the design of a structured mechanism for dealing with sovereign debt restructuring, as well as the role of credit rating agencies, and provides a basis for deliberation of related policy issues.

II. Recent trends

2. The total external debt of developing countries and countries with economies in transition (henceforth referred to as developing countries) surpassed $4 trillion by the end of 2010 (see annex). This corresponds to a 12 per cent increase in total external debt compared to 2009, marking a much higher growth rate in comparison to previous years. While data for 2011 from the World Bank Debtor Reporting System are not yet available, estimates made by the United Nations Conference on Trade and Development (UNCTAD) secretariat indicate that debt levels continued to grow by approximately 12 per cent over 2010-2011, bringing the total external debt of developing countries to $4.5 trillion.

3. Export and gross domestic product (GDP) growth in the developing world have compensated for this recent increase in debt and have led to a decrease in debt ratios. Average debt decreased from nearly 80 per cent of exports in 2009 to approximately 71 per cent of exports in 2010 and the average debt to gross national income (GNI) ratio decreased slightly from 21.8 per cent to 20.4 per cent in 2010. Estimates for 2011 suggest a further decrease in debt to 65 per cent of exports and 19.5 per cent of GNI for the year.

4. Most of the recent increase in debt was due to short-term borrowing linked to trade credit which, in turn, was associated with rapid import growth in developing countries. Total short-term external debt went from $773 billion in 2009 to more than $1 trillion in 2010. Preliminary data indicate that short-term debt surpassed $1.2 trillion in 2011. This increase in short-term borrowing is unlikely to lead to liquidity problems due to its nature (trade credit) and to the fact that most countries (112 out of 116 countries for which 2010 data are available) have international reserves that cover more than 100 per cent of their short-term debt. In the majority of countries (86 out of 116), the international reserves to short-term debt ratio increased over the period from 2006 to 2010.

5. Total international reserves of developing countries also surpassed their stock of total external debt. Therefore, developing countries, as a group, are net creditors (see A/66/164). However, this average masks substantial heterogeneity among developing countries. Out of 123 countries for which data are available, only 28 countries do not have net external debt. In the other 95 countries, total external debt is higher than international reserves. In 55 of those countries, external debt is at least twice as large as international reserves and in 31 of them external debt is more than three times the size of international reserves.

6. During 2010, official financial flows to developing countries decreased from the 2009 peak of $80.5 billion to $71.2 billion. Bilateral financial flows increased from $6.7 billion to $11.9 billion and multilateral flows decreased from $73.7 billion to $59.4 billion. Within multilateral flows, 2010 witnessed a small decline in financing from the International Development Association (IDA), an increase in financing from the International Bank for Reconstruction and Development and a large drop in financing from the International Monetary Fund (IMF) to developing countries.[1]

7. Lending is concentrated among a small number of countries. In 2010, the top 10 borrowers accounted for 64 per cent of the total stock of external debt of developing countries and for 72 per cent of net debt inflows into developing countries. The top 10 borrowers also accounted for 56 per cent of total sovereign bond issuances and 86 per cent of total corporate bond issuances.[1]

8. Eastern Europe and Central Asia account for nearly 30 per cent of the total external debt of developing countries. The region has the highest external debt to GNI ratio and, together with Latin America and the Caribbean, the highest debt to export ratio. The stock of external debt, which grew rapidly over the period 2005-2009, is now stabilizing and debt ratios are improving. The average debt to GNI ratio dropped from 45 per cent in 2009 to 41 per cent in 2010 and is estimated to have decreased to 36 per cent in 2011. Total debt went from 145 per cent of exports in 2009 to an estimated 100 per cent of exports in 2011. While the cost of borrowing for the region has come down from the peak reached in late 2008 and early 2009, credit remains expensive and debt service continues to absorb 20 per cent of export revenues.

9. Higher debt ratios are partly mitigated by large holdings of international reserves and a healthy reserve to short-term debt ratio of 325 per cent. While in most regions the public sector is the largest borrower, in Eastern Europe and Central Asia more than 60 per cent of total long-term external debt is owed by private borrowers, down from more than 70 per cent in 2007 (see A/64/167 for a discussion of the dangers of private sector borrowing).

10. The stock of total external debt of Latin America and the Caribbean surpassed $1 trillion in 2010 and was estimated at $1.2 trillion in 2011. Rapid growth in the value of the region's exports led to a decrease in the debt to export ratio from 113 per cent in 2009 to 105 per cent in 2010 and an estimated 101 per cent in 2011. Output growth was slower than export growth and the debt to GNI ratio, which had dropped by 1.5 percentage points in 2010, is estimated to have increased by nearly one percentage point during 2011. Several small Caribbean economies (Belize, Dominica, Grenada and Jamaica) are characterized by high levels of external debt and some Caribbean economies also have high levels of domestic public debt (more than 100 per cent of GDP in the case of Barbados and Jamaica).

11. Latin America and the Caribbean also witnessed a rapid increase in private sector debt. The rapid increase in short-term debt and in borrowing by banks and non-financial corporations may signal that some large Latin American players are involved in carry-trade operations aimed at exploiting the large interest rate differentials between the region and the major financial centres. Such carry-trade operations may have negative consequences in terms of currency appreciation in the

[1] World Bank, *Global Development Finance 2012*, table 5.

short-run and currency crises in the long-run (for a discussion of carry trade see A/66/164).

12. The dollar value of the stock of total external debt of the East Asia and the Pacific region is similar to that of Latin America and the Caribbean. The region is characterized by high levels of short-term debt (50 per cent of total external debt in 2011). Vulnerabilities associated with short-term borrowing are, however, mitigated by high reserve coverage ratios. The increase in total debt over the period from 2009 to 2011 was outpaced by rapid growth in the value of exports and total external debt decreased from 42 per cent of exports in 2009 to 39 per cent of exports in 2011. Nominal output growth was in line with debt growth and the debt remained stable at approximately 13 per cent of GNI.

13. In South Asia, total external debt increased from $350 billion in 2008 to an estimated $440 billion in 2011, about 10 per cent of the total external debt of developing countries. Total external debt declined from 110 per cent of exports in 2009 to an estimated 90 per cent of exports in 2011. The region's debt to GNI ratio, instead, remained stable at about 20 per cent. These averages mask large differences between the two largest economies in the region, with India having external debt ratios that are about half those of Pakistan.

14. Sub-Saharan Africa accounts for 5 per cent of the total external debt of developing countries. Over the last two years, the region has been characterized by moderate debt growth and an improvement in debt ratios, partly due to debt restructuring and rescheduling and cancellation by official creditors. Most long-term debt is owed by sovereign debtors to official lenders and only 10 per cent of total long-term external debt is owed by private borrowers. This is the only region in which net official flows from bilateral creditors are almost equal to flows from multilateral creditors and in which countries, which are not members of the Organization for Economic Cooperation and Development (OECD) are becoming large lenders.

15. Over the last two years, the total external debt stock of countries in the Middle East and North Africa region increased only slightly, from $141 billion in 2009 to an estimated $144 billion in 2011. Debt ratios remain the lowest among the developing regions surveyed in this report. Private debt flows are limited: 95 per cent of the long-term external debt of the Middle East and North Africa region is owed by sovereign borrowers and more than 60 per cent of total long-term debt is due to official lenders. Over 2010, flows from official creditors dropped by about 50 per cent because of increased principal repayments and a sudden slowdown in disbursements to Egypt and Morocco.[1]

III. Debt situation of the least developed countries

16. The total external debt of the 48 countries that belong to the group of least developed countries remained stable at approximately $158 billion during 2010 but increased to an estimated $170 billion in the course of 2011. In 2008, external debt represented 84 per cent of their exports and 31 per cent of the group's GNI. The debt to export ratio increased rapidly during 2009, reaching a new peak of 114 per cent. It then started to decrease in 2010, first to 91 per cent and then to an estimated 83 per cent in 2011 (more than 17 percentage points above the average of developing countries). The debt to GNI ratio of the least developed countries

decreased from 31.8 per cent in 2009 to an estimated 27.8 per cent in 2011, still more than 8 percentage points higher than the average of developing countries.

17. Most of the external debt of the least developed countries is long term (83 per cent of the total in 2011) and the majority of long-term debt is owed to official creditors (87 per cent of the total) by sovereign borrowers (96 per cent of the total). Since a large share of their external debt is on concessional terms, the average debt service costs as a percentage of GDP and exports are lower than those of the average developing country.

18. Even though debt ratios have been improving, many of the least developed countries remain in debt distress or at high risk of debt distress. According to the latest debt sustainability analyses, the three least developed countries which were in debt distress in 2010 (the Comoros, Guinea and the Sudan) remained in debt distress in 2011. Similarly, 9 of the 10 least developed countries which were at high risk of debt distress in 2010, continued to be at high risk of debt distress in 2011 (Guinea-Bissau switched from high to moderate risk of distress in 2011) and one new country (Kiribati) joined the list of least developed countries at high risk of debt distress. Thus, the number of the least developed countries in debt distress or at high risk of debt distress has not changed.[2]

19. The least developed countries have been relying more on domestic borrowing. Over the period from 2007 to 2010, domestic public debt increased in 14 of the 23 low-income countries for which data are available. The average increase in domestic public debt in this sample of 23 low-income countries was 2.5 per cent of GDP. Domestic borrowing needs to be complemented by external financial flows because most of the least developed countries (42 out of 46 countries for which data are available) are still running current account deficits. In some cases, these current account deficits are large and probably unsustainable. For instance, in 2011 there were 13 such countries, which had current account deficits of at least 15 per cent of GNI.

20. Within the group of least developed countries, there are large differences between commodity-exporting and commodity-importing countries. The recent decline in commodity prices from the April 2011 peak may reverse this situation and lead to a deterioration in economic conditions in those countries which are dependent on commodity exports. Commodity price volatility makes the least developed countries particularly vulnerable to aid shortfalls. While these countries need to gradually adjust their external imbalances, this adjustment process needs to be accompanied and facilitated by stable concessional financial flows.

21. The United Nations uses a holistic approach based on income per capita, human assets and economic vulnerability to classify countries as least developed, whereas the Bretton Woods institutions only base country groupings on income per capita.[3] As a consequence, there are 16 least developed countries which are classified as middle-income countries and one (Equatorial Guinea) which is classified as a high-income country. This is problematic because graduation from low- to middle-income status often leads to a rapid decline in development assistance. For instance, countries no longer qualify for IDA soft loans after their GNI per capita exceeds the

[2] IMF list of low-income country debt sustainability analyses for countries eligible for the Poverty Reduction and Growth Trust as of 8 March 2012.

[3] Low-income countries are defined as countries with a 2010 purchasing power parity-adjusted GNI per capita below $1,005.

low-income threshold for three years in a row. The fact that many countries have graduated from low- to middle-income status has thus resulted in a situation in which major forms of aid do not target countries where the majority of the poor live.[4]

IV. Role of credit rating agencies: proposals for reform

22. The main objective of credit rating agencies is to reduce informational asymmetries between lenders and borrowers by determining the ability and willingness of potential borrowers to meet their debt servicing obligations. The global financial crisis has given a new impetus to the debate on the role and effectiveness of credit rating agencies and on their impact on the stability of the global financial system.

23. The rapid downgrades of top-rated structured products raised doubts as to the soundness of the methodology used by the major credit rating agencies. The recent increase in sovereign risk has also refocused attention on the "cliff effects" that occur when credit ratings are downgraded below key thresholds.

24. These concerns have led to a number of reform proposals. In the previous report on this subject (A/66/164), a specific proposal aimed at reducing conflicts of interest by breaking the commercial link between issuers and ra.ing agencies was discussed. Other proposals are aimed at increasing competition in the credit rating industry. While a survey of the rating industry has identified more than 70 credit rating agencies, only a small number of these agencies are officially recognized for supervisory purposes. In the United Sates there are only 10 "nationally recognized statistically registered organizations", of which three (Standard & Poor's, Moody's and Fitch) control more than 95 per cent of the worldwide industry market.[5] Greater competition could be achieved by favouring the entry of new players and by requiring issuers to rotate among agencies every few years. Critics of such proposals maintain that increased competition may reduce the reputational capital of the agencies and thus aggravate conflicts of interest and lead to rating inflation.

25. In the United States of America, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, eliminated many statutory and regulatory requirements relating to the use of ratings provided by the nationally recognized statistically registered organizations. Certain provisions of the Act require greater transparency of rating procedures and methodologies, give the Securities and Exchange Commission greater oversight power over these organizations and impose stricter liabilities for credit rating agencies which do not follow the rules and regulations. During 2011, the Securities and Exchange Commission conducted its first annual review of each of the 10 nationally recognized statistically registered organizations. It reported that in some instances rating agencies failed to follow their own rating methodologies and procedures, did not make timely and accurate disclosures and did not establish effective internal control structures to manage conflicts of interest.

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[4] Ravi Kanbur and Andy Sumner, "Poor countries or poor people? Development assistance and the new geography of global poverty", DP 8489 (London, Centre for Economic Policy Research, 2011).

[5] M. El-Khoury, "Credit ratings and their role in the international financial system", forthcoming in 2012 from UNCTAD.

26. The new European Union regulation, introduced in Decemb r 2010 and amended in May 2011, requires mandatory registrat on of all credit rating agencies operating in the European Union and establishes a set of rules aimed at limiting conflicts of interest. The new regulation also includes a surveillance regime for rating agencies, to be undertaken by the newly established European Securities and Markets Authority. However, so far the Authority has allocated only a small share of its resources to the supervision of the rating agencies.[6] There have also been proposals (which, however, faced the opposition of some member States) to give European regulators the authority to bar the publication of rating updates in exceptional circumstances and for the creation of a publicly funded European rating agency.

27. Overall, these reform initiatives target four main objectives:

(a) To reduce the reliance of the financial system on the services of the rating agencies and to increase incentives for investors to implement their own risk assessment. With this objective in mind, the rating agencies and rated entities will be asked to disclose more and better information underlying their rating decisions;

(b) To reduce the impact of "cliff effects" by having more transparent and more frequent debt ratings. This is particularly important for sovereign ratings which tend to have a systemic nature;

(c) To eliminate conflicts of interest and incorporate different views in the rating process. With this objective in mind, the new regulation requires two ratings from different agencies for complex structured instruments and requires issuers to rotate their credit rating agency every three years. The new European legislation prohibits large cross-shareholdings among rating agencies and American legislation requires that at least half the members of the boards of nationally recognized statistically registered organizations be independent, with no financial stake in credit ratings;

(d) To increase the incentives to provide accurate ratings by making rating agencies liable in case they intentionally (or with gross negligence) infringe upon regulations and thus cause damage to investors who relied on their ratings.

28. The international community needs to continue to work to find ways to develop a regulatory framework that can limit the herd behaviour of investors that is brought about by sudden changes in sovereign ratings. A recent report suggests the creation of a United Nations observatory of credit rating service providers. Among other things, this observatory would certify credit rating products and build consensus on international standards for rating methodologies.[6]

V. Issues relating to sovereign debt restructuring

29. Debt contracts, either domestic or external, in which the borrower is a sovereign Government, are different from private debt contracts. In the case of domestic debt, the sovereign is a large player. It is usually the safest borrower in the country and its debt instruments are normally the most liquid and are used as a benchmark for pricing domestic debt instruments. When the debt is denominated in the domestic currency and the country has its own currency, the Government can

[6] Infrangilis, *Rating Credit Raters: Sovereign Credit Rating Agencies — Political Scapegoats or Misguided Messengers?* (Manchester, United Kingdom, June 2012).

always monetize its public debt. While monetizing debt is a hotly discussed issue, it reduces the likelihood that the Government will be unable to service its debts. The situation is different when a country issues debt in a foreign currency or, more generally, in a currency over which it does not have complete control.

30. Where there is a foreign currency debt, Governments can find themselves in a situation in which they are unable to service their debts.[7] However, while national commercial codes contain well-defined procedures for enforcing private debt contracts and for dealing with private bankruptcies, in the case of sovereign debt, creditors have limited legal recourse. Limited enforceability is only partly due to the principle of sovereign immunity which protects sovereign States from lawsuits in foreign courts. Recent legal interpretations suggest that sovereign immunity may not apply to debt contracts and sovereign borrowers can waive their immunity (as a consequence, sovereign States have been successfully sued in foreign courts), but rulings by foreign courts remain difficult to enforce because creditors can only attach assets located outside a country's border.[8]

31. Limited enforceability does not prevent the creation of a mechanism for facilitating the restructuring of sovereign debt. However the desirability of such a structured mechanism remains a contentious issue. Those who favour reform in this direction suggest that the lack of a structured mechanism is a major failure of the current international financial architecture, which leads to long delays in debt restructuring, unfair outcomes and loss of value for both debtors and creditors. Those who oppose the creation of such a mechanism instead argue that the current system has all the necessary contractual instruments for dealing with sovereign defaults and that the creation of a new institution for dealing with sovereign insolvencies would be useless at best and harmful at worst.

32. The debate over whether the international system needs a mechanism for dealing with sovereign defaults started in the mid-1970s when Göran Ohlin wrote that "Development finance needs something like the institution of 'honourable bankruptcy'".[9] From the very beginning, the United Nations system has played a leading role in the discussion on sovereign debt restructuring. In 1977, UNCTAD called for explicit principles for debt rescheduling (TD/AC 2/9). In 1980, the UNCTAD Trade and Development Board endorsed a set of detailed features for future operations relating to the debt problems of interested developing countries in which it concluded that "in the multilateral forum agreed upon by the debtor and creditors, the Chairman would conduct the debt operation in a fair impartial manner, in accordance with the agreed objectives, so as to lead to equitable results in the context of international economic cooperation" (resolution 222 (XXI), sect. B). In 1986, the UNCTAD *Trade and Development Report* included a detailed proposal for

[7] The presence of foreign currency debt is particularly problematic when a country needs a real depreciation in order to restore competitiveness. In this case, exchange rate overshooting may lead to a large and sudden jump in the debt to GDP ratio.

[8] For details see Ugo Panizza, Federico Sturzenegger and Jeromin Zettelmeyer, "The economics and law of sovereign debt and sovereign default", *Journal of Economic Literature*, vol. 47, No. 3 (September 2009).

[9] Göran Ohlin, "Debts, Development and Default" in *A World Divided: The Less Developed Countries in the International Economy*, G. K. Helleiner, ed. (Cambridge, Cambridge University Press, 1976). As quoted in Kenneth Rogoff and Jeromin Zettelmeyer (2002) "Early ideas on sovereign bankruptcy reorganization: a survey", working paper No. 02/57 (Washington, D.C., IMF, 2002) available from www.imf.org/external/pubs/cat/longres.cfm?sk=15752.0.

establishing a procedure for sovereign debt restructuring based on chapter 11 of the United States Bankruptcy Reform Act of 1978. The need for an insolvency procedure for sovereign debt was also discussed in the 1998, 2001 and 2009 issues of the *Trade and Development Report*.

33. In 2001, the IMF management put forward a proposal for creating a sovereign debt restructuring mechanism mostly aimed at dealing with collective action problems brought about by the presence of dispersed bondholders. This proposal was then abandoned and, as an alternative, countries started issuing bonds with collective action clauses allowing a majority of bondholders to amend the terms and conditions of the bonds.

34. There is now an increasing demand for reopening the international discussion on the desirability of a structured approach to sovereign debt restructuring. The General Assembly decided to devote one special event during its sixty-seventh session to the ongoing work on sovereign debt restructuring and debt resolution mechanisms (resolution 66/189, para. 27), and a communiqué of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development in April 2012 stated that the euro area crisis had also highlighted the need for further study of sovereign debt restructuring mechanisms.

35. The ideal starting point for such a discussion is a careful analysis of the problems that such a mechanism should address. The literature on sovereign debt and sovereign default has highlighted five problems with the current market-based approach to sovereign debt restructuring:

(a) The lack of an established procedure and a clear set of rules for dealing with sovereign insolvencies often results in lengthy debt renegotiations which, in some cases, do not restore debt sustainability.[10] These inefficiencies were at the root of the original proposals for the creation of a mechanism for restructuring sovereign debt;

(b) Dispersed creditors and bondholders have an incentive to holdout from debt restructuring deals. Coordination and hold-out problems are exacerbated by the presence of vulture creditors, who buy the debt at a deep discount on the secondary market with the intention of litigating, after the majority of creditors have reached a settlement with the defaulting country;

(c) Countries that are in the process of restructuring their debts cannot access private interim financing because such financing is not senior with respect to existing claims. Lack of access to private interim financing may amplify the crisis and further reduce ability to pay because, during the restructuring period, countries may need access to external funds, either to support trade or to finance a primary current account deficit. Interim financing is usually provided by the IMF and other official lenders which are de facto (but not de jure) senior with respect to private claims. However the official sector may not have enough funds and its intervention may generate moral hazard problems;

[10] A study of 90 defaults and renegotiations on debt owed to private creditors by 73 countries found that debt renegotiations have an average length of over 7 years, produce average creditor losses of 40 per cent and lead to limited debt relief. See Mark Wright, "Restructuring sovereign debts with private sector creditors: theory and practice" in *Sovereign Debt and the Financial Crisis: Will This Time Be Different?*, Carlos Braga and Gallina Vincelette, eds. (Washington, D.C., World Bank, 2010).

(d) Lack of a seniority structure can lead to overborrowing caused by debt dilution (i.e. a situation in which, when a country approaches financial distress, new debt issuances hurt existing creditors) and increase borrowing costs ex ante.[11] In the corporate world, debt dilution is not a problem because courts can enforce seniority rules. This is instead a problem for sovereign debt because, after a sovereign default, all creditors, old and new, are treated in the same way. A debt resolution mechanism capable of enforcing seniority would thus have two advantages: it would allow for interim financing (through debtor-in-possession provisions) and it would prevent debt dilution and thus reduce borrowing costs and overborrowing;

(e) The last problem has to do with the timing of sovereign defaults. While most economic models of sovereign debt assume that countries have an incentive to default too much or too early, there is now evidence that countries often try to postpone the moment of reckoning and may suboptimally delay the beginning of an unavoidable debt restructuring process.[12] Delayed default, in turn, may lead to destruction of value because a prolonged pre-default crisis may reduce both ability and willingness to pay, making both lenders and borrowers worse off.

36. Any discussion on the desirability of a mechanism for the resolution of sovereign debt crises should spell out which of these problems could or should be addressed. For instance, some opponents of the creation of a structured mechanism argue that, since collective action clauses can address creditor coordination and hold-out problems, they were a reasonable substitute for the original sovereign debt restructuring mechanism project. However, the introduction of collective action clauses cannot be used to argue against a structured mechanism aimed at addressing any of the other problems listed above.[13]

37. Another possible reason for opposing the creation of a structured mechanism for solving sovereign debt crises is that, by reducing the costs of default, such a mechanism would reduce willingness to pay and ultimately result in higher borrowing costs. The fear of higher borrowing costs was one of the key reasons why several emerging market countries opposed the creation of the IMF-sponsored sovereign debt restructuring mechanism. Does this fear of higher borrowing cost have a sound theoretical or empirical basis?

38. From a theoretical point of view, the answer is not clear. On the one hand, in the presence of non-enforceable contracts, willingness to pay is linked to the costs of default brought about by the inefficiencies which are present in the current system. Therefore, removing these inefficiencies would reduce the costs of default and increase borrowing costs. On the other hand, the presence of debt overhang and delayed defaults may lead to a loss of value for both debtors and creditors, and debt dilution leads to overborrowing and higher borrowing costs. A mechanism that could address these problems could therefore increase recovery value and lead to lower borrowing costs.

[11] See Patrick Bolton and Olivier Jeanne, "Structuring and restructuring sovereign debt: the role of a bankruptcy regime", *Journal of Political Economy*, vol. 115, No. 6 (December 2007).

[12] Eduardo Levy Yeyati and Ugo Panizza, "The elusive costs of sovereign defaults", *Journal of Development Economics*, vol. 94, No. 1 (January 2011).

[13] In fact, collective action clauses may not even fully solve creditor coordination because they may fail to aggregate the claims of different classes of creditors.

39. From an empirical perspective, it is impossible to conduct a direct test of the hypothesis that the creation of a debt resolution mechanism would increase borrowing costs. However, it is possible to check whether other innovations that facilitate sovereign debt restructuring have an effect on borrowing costs. When collective action clauses were first introduced into New York law bonds, it was feared that, by reducing the costs of default, they would increase borrowing costs. There is now evidence that they have no impact on borrowing costs.

40. A third objection to the creation of a structured mechanism relates to the fact that, since there are no well-defined criteria for establishing capacity to pay, the mechanism could be subject to political pressure and decisions would be influenced by geopolitical considerations. Any proposal should therefore start with a discussion of what safeguards could guarantee the independence of a body in charge of adjudicating on sovereign claims.

41. While these contrasting views indicate that the international community is still far from a consensus on the costs and benefits of a structured mechanism for dealing with sovereign debt restructuring, it also proves that this is an important issue which should be brought back to the centre of the international debate. This debate should also recognize that, while debt restructuring may be necessary for resolving a debt crisis, GDP growth remains essential for reducing debt ratios.[14]

42. Debt restructuring will play a useful role only if it frees up resources for implementing growth-enhancing macroeconomic policies, but it will not restore sustainability if it is accompanied by restrictive macroeconomic policies. If there is unused capacity, an expansionary fiscal policy will not crowd out private expenditure, especially if accompanied by an accommodating monetary policy aimed at keeping interest rates low. In fact, such a policy can stimulate growth and investment and reduce debt ratios. If external constraints prevent the implementation of such accommodating macroeconomic policies, the international and regional financial institutions should provide the necessary support and help countries in crisis to resolve their balance of payments problems without introducing contractionary austerity measures.

VI. Debt relief and official development assistance

Heavily indebted poor countries initiative and progress on the multilateral debt relief initiative

43. In 1996, the heavily indebted poor countries (HIPC) initiative was launched to remove the debt overhang from highly indebted poor countries. The initiative was modified in 1999 to deliver faster and broader debt relief which incorporated poverty reduction strategies that were in line with the pursuit of the Millennium Development Goals. The countries that complete the HIPC initiative also benefit from additional debt relief under the multilateral debt relief initiative (MDRI).

44. The pace of progress has slowed considerably as the initiative winds down. Since the spring of 2011, little progress has been made under the HIPC initiative:

[14] For a detailed discussion of this, see UNCTAD, *Trade and Development Report, 2011*, chaps. 2 and 3.

exchange among donors would help to avoid duplication and increase efficiency and collaboration.[21]

52. Ultimately, it is in times of crisis that the importance of aid increases and it is through unity, solidarity and cooperation that the international community draws its strength. As global economic growth prospects hang in the balance, the provision of aid to the most vulnerable to achieve the Millennium Development Goals and to help shield them from adverse economic shocks becomes crucial.

Paris Club activities

53. The past 12 months have witnessed a dwindling of the number of Paris Club meetings, as over the last decade a number of countries have reached their HIPC completion points and exited the rescheduling process.

54. Following the political upheaval in Côte d'Ivoire surrounding the 2010 presidential election, the country delegation came to meet its Paris Club creditors on 15 November 2011. Côte d'Ivoire benefited from Cologne terms on its non-previously rescheduled debt as well as on its previously rescheduled debt. Furthermore, Paris Club creditors agreed to defer and reschedule, over a 10-year period, the repayment of maturities on short-term and post-cut-off date debts, as well as the arrears on those claims. The moratorium interest due was deferred over a period of six years. In June 2012, Côte d'Ivoire came to the Paris Club for the second time after reaching the completion point under the HIPC initiative. The country obtained a full cancellation of its non-ODA, non-previously rescheduled debt, as well as previously rescheduled debt from 1994, 1998 and 2002. The overall treatment of the debt translates into a cancellation of $1.77 billion and a commitment to cancel an additional $4.73 billion on a bilateral and voluntary basis. The agreement eliminates over 99 per cent of the debt Côte d'Ivoire owed to Paris Club creditors.

55. In April 2011, Guinea concluded an agreement with Paris Club creditors to reschedule under Cologne terms its obligations falling due between 2012 and 2014. The agreement covers both non-previously rescheduled and previously rescheduled debt, as well as post-cut-off date debt and short-term debt, including the deferral of arrears on those debts and the capitalization of moratorium interest.

56. The rescheduling terms obtained by both Côte d'Ivoire and Guinea went beyond standard Cologne treatments, reflecting the intention of the international community to support the efforts of those countries to stabilize their economies and achieve sustainable growth.

57. In May 2012, Saint Kitts and Nevis concluded an agreement with Paris Club creditors to reschedule its debt under classic terms. The principal, interest and late interest due and not paid as of 30 April 2012 were immediately rescheduled over 21.5 years, while it was agreed that maturities falling due from May 2012 to June 2014 would be similarly treated, provided that the country stays on track in its IMF-supported programme. The total amount of debt treated was $5 million.

[21] See World Bank, *Global Monitoring Report 2012: Food Prices, Nutrition, and the Millennium Development Goals* (Washington, D.C., World Bank, 2012), chap. 5.

VII. Conclusions and policy recommendations

58. Thus far, developing countries have on the whole remained resilient amid the global financial instability created by the European crisis. External debt ratios continued to improve in most developing regions (the exceptions are Latin America and South Asia, where the 2011 debt to GNI ratios are expected to increase slightly with respect to their 2010 values) and also in the group of the 48 least developed countries. However, many countries may now be facing vulnerabilities related to their increasing domestic public debt. Moreover, the regional averages discussed in this report mask substantial heterogeneity, with a number of countries still in debt distress or at high risk of debt distress, including some countries that have just completed the HIPC initiative. The increasing importance of short-term debt may also lead to greater vulnerabilities, especially if the situation in Europe deteriorates, thereby hurting the fragile growth performance of developing countries.

59. While costly crises are sometimes driven by exogenous shocks, they may also be caused by irresponsible behaviour from both lenders and borrowers. Prudent behaviour can thus limit the cost and prevalence of debt crises. With this objective in mind, the UNCTAD secretariat has developed a set of principles on responsible sovereign lending and borrowing which have gained support from a growing number of developing and developed countries.

60. At the BRICS (Brazil, Russian Federation, India, China and South Africa) summit that took place in New Delhi in March 2012, the participants decided to set up a working group to study the possibility of creating a new development bank for mobilizing resources for infrastructure and sustainable development projects in the BRICS countries and other emerging and developing economies. Such a bank could be partly financed with the large stock of international reserves accumulated by developing and transition economies and currently invested in low-return Government bonds issued by the advanced economies. A reallocation of international reserves away from the developed economies could also contribute to stimulating demand in the developing world and thus contribute to addressing current macroeconomic imbalances.

61. Credit rating agencies remain crucial players in the international financial architecture. The rating industry, however, needs to be reformed in order to limit conflicts of interest and the potentially disruptive effects of rating actions.

62. There is new interest in reopening the debate on the creation of a structured mechanism for dealing with sovereign debt restructuring. The first step in opening this debate should be a clear definition of the problems that such a mechanism should address.

Annex

External debt of developing countries[a, b]

(Billions of United States dollars)

	All developing countries and countries with economies in transition					*Sub-Saharan Africa*				
	2000-2007	*2008*	*2009*	*2010*	*2011*	*2000-2007*	*2008*	*2009*	*2010*	*2011*
Total debt stocks	2 467.3	3 498.2	3 638.6	4 075.3	4 553.3	207.3	195.9	198.8	205.0	221.4
Long-term debt	1 952.6	2 713.0	2 812.1	2 974.3	3 260.5	168.3	143.7	156.3	161.1	181.8
Private (share)	62.5	73.8	72.6	72.4	74.5	23.8	33.4	34.0	34.1	32.0
Private PNG (share)	32.4	48.5	47.5	46.8	49.3	6.2	9.9	11.0	11.7	10.8
Short-term debt	450.1	759.5	773.2	1 036.4	1 217.9	33.1	48.2	36.3	37.9	29.1
Arrears	94.8	76.6	77.4	62.0	59.3	39.4	34.3	30.6	28.8	28.5
Debt service	394.8	538.8	508.9	583.3	693.8	15.4	14.0	13.6	12.6	11.9
International reserves	1 659.8	4 167.2	4 797.9	5 508.5	6 098.2	68.5	156.2	157.8	158.6	182.3
Debt indicators (percentage)										
Debt service/exports[c]	14.9	9.4	11.1	10.0	9.8	8.4	3.4	4.7	3.4	2.7
Total debt/exports	92.4	61.2	79.7	70.7	65.4	110.5	48.8	66.6	54.4	48.5
Debt service/GNI	4.7	3.1	3.0	2.9	2.9	3.0	1.4	1.5	1.2	1.0
Total debt/GNI	29.4	20.5	21.8	20.4	19.6	40.1	20.6	21.9	19.7	18.7
Reserves/short-term debt	376.6	564.2	633.9	540.2	507.8	203.3	314.8	426.0	412.1	619.1
Reserves/M2	26.0	32.3	29.8	28.4	27.1	31.3	39.0	32.7	28.6	33.1

	Middle East and North Africa					*Latin America and Caribbean*				
	2000-2007	*2008*	*2009*	*2010*	*2011*	*2000-2007*	*2008*	*2009*	*2010*	*2011*
Total debt stocks	147.3	137.9	141.0	143.6	144.2	771.0	882.3	899.1	1 038.7	1 230.9
Long-term debt	124.8	116.9	118.4	119.9	122.7	637.4	731.3	751.5	828.2	968.1
Private (share)	31.7	36.5	34.4	35.3	36.9	78.6	82.1	80.2	79.6	84.5
Private PNG (share)	4.5	5.7	5.2	5.1	4.1	34.8	42.9	42.8	44.7	52.2
Short-term debt	21.0	20.8	22.4	23.5	23.0	111.5	150.2	146.4	208.3	259.8
Arrears	8.5	0.7	0.7	0.8	0.8	21.1	30.2	32.1	16.3	15.7
Debt service	20.1	21.7	18.2	17.1	18.2	155.9	147.9	138.1	140.2	164.8
International reserves	147.7	339.5	350.5	375.7	409.1	238.3	497.4	551.3	639.6	747.7
Debt indicators (percentage)										
Debt service/exports[c]	11.3	5.9	6.2	4.9	4.6	28.0	14.9	17.5	14.2	13.6
Total debt/exports	82.8	37.2	48.2	41.4	36.6	138.7	88.7	113.7	105.1	101.5
Debt service/GNI	4.0	2.3	1.9	1.6	1.5	6.7	3.6	3.6	2.9	3.0
Total debt/GNI	29.3	14.6	14.7	13.3	11.9	33.2	21.3	23.3	21.7	22.5
Reserves/short-term debt	703.6	1 634.9	1 564.6	1 596.7	1 776.4	213.7	331.2	376.6	307.1	287.8
Reserves/M2	39.7	54.5	49.6	49.2	50.3	21.4	26.9	22.5	22.2	24.2

	East Asia and Pacific					*South Asia*				
	2000-2007	*2008*	*2009*	*2010*	*2011*	*2000-2007*	*2008*	*2009*	*2010*	*2011*
Total debt stocks	577.1	754.7	833.8	1 014.0	1 199.3	197.1	321.1	353.4	400.6	440.7
Long-term debt	408.1	491.2	506.7	545.2	612.5	180.0	266.3	292.2	325.8	345.4
Private (share)	57.2	60.5	60.2	61.9	67.5	38.4	48.3	50.2	52.1	55.8
Private PNG (share)	35.3	43.1	41.8	43.7	47.5	27.3	41.4	42.0	40.3	43.3
Short-term debt	159.8	263.3	326.9	468.5	584.1	14.8	49.5	52.1	63.9	82.6
Arrears	13.7	6.6	7.0	7.6	7.8	0.3	0.1	0.2	0.3	0.3
Debt service	86.4	95.3	101.2	132.8	184.8	24.8	36.5	22.8	27.4	34.5
International reserves	810.6	2 263.9	2 780.4	3 310.9	3 717.9	135.4	268.6	299.9	315.5	312.4
Debt indicators (percentage)										
Debt service/exports[c]	7.9	4.1	5.1	5.2	6.1	15.8	10.1	7.3	6.6	7.0
Total debt/exports	52.6	32.4	42.3	39.6	39.4	124.9	88.1	112.4	96.5	89.4
Debt service/GNI	3.2	1.6	1.6	1.8	2.0	2.7	2.4	1.3	1.3	1.6
Total debt/GNI	21.5	12.9	13.2	13.4	13.0	21.7	21.0	20.8	19.2	19.8
Reserves/short-term debt	507.4	860.1	850.8	707.0	636.9	913.1	543.0	575.4	494.7	378.5
Reserves/M2	22.4	28.8	27.9	27.1	25.0	24.2	26.6	24.5	21.1	20.2

	Europe and Central Asia				
	2000-2007	*2008*	*2009*	*2010*	*2011*
Total debt stocks	567.5	1 206.2	1 212.4	1 273.4	1 316.8
Long-term debt	434.0	963.5	987.1	994.2	1 030.0
Private (share)	77.7	91.9	90.5	89.4	87.4
Private PNG (share)	46.3	68.5	66.5	63.1	61.9
Short-term debt	109.8	227.5	189.1	234.2	239.3
Arrears	11.8	4.7	6.8	8.3	6.4
Debt service	92.3	223.5	214.8	253.2	279.4
International reserves	259.2	641.6	658.0	708.1	728.8
Debt indicators (percentage)					
Debt service/exports[c]	19.5	19.0	26.0	24.7	21.1
Total debt/exports	117.9	102.2	145.5	125.8	100.9
Debt service/GNI	6.7	6.5	8.1	8.0	7.5
Total debt/GNI	40.5	35.2	45.3	40.8	35.8
Reserves/short-term debt	256.0	308.6	378.3	323.0	325.5
Reserves/M2	51.6	54.9	51.0	46.7	45.1

Source: UNCTAD calculations based on World Bank, *Global Development Finance 2012* (online database).

[a] Developing countries as defined in *Global Development Finance*.

[b] 2011 values are estimates.

[c] Exports comprise the total value of goods and services exported.

the only instance of a country graduating to a new stage under the initiative occurred in June 2012 when Côte d'Ivoire reached the completion point. The countries that have yet to reach the decision point face fragile political situations and their progress towards the decision point is uncertain. As of mid-June 2012, 33 countries had reached the completion point and 3 countries (Chad, Comoros and Guinea) had reached the decision point under the initiative. It is anticipated that two of the three decision point countries will graduate to the completion point in the second half of 2012.

45. With respect to the eligible HIPCs that have yet to reach the decision point, in December 2011 it was decided to further restrict the list of eligible HIPCs.[15] The decision amended the eligibility criteria and further ring-fenced the list of eligible countries to benefit from debt relief under the initiative. This effectively eliminated three countries (Bhutan, Kyrgyzstan and the Lao People's Democratic Republic) whose external debt was determined to be below the indebtedness thresholds as of the end of 2010.[16] The countries that did meet the indebtedness criterion and that remain eligible for HIPC and MDRI debt relief include Eritrea, Nepal, Somalia and the Sudan. However, Nepal has indicated that it does not wish to avail itself of assistance under the initiative.

46. Since the launch of the enhanced HIPC initiative, countries have undergone improvements with respect to some debt indicators. During the period from 2001 to 2010, the 36 decision point countries have undergone reductions in average debt service to GDP ratios (from 3.1 per cent to 0.9 per cent) and increases in poverty-reducing expenditure to GDP ratios (from 6.2 per cent to 9.5 per cent).[17] However HIPCs have made uneven progress towards achieving the Millennium Development Goals and debt sustainability. Of the 33 countries which had reached the completion point under the initiative as of June 2012, 7 are classified as being at high risk of debt distress, 13 are classified as being at moderate risk, and 13 as low risk. Of the remaining decision point countries, one is classified as being in debt distress, one is classified as being at high risk of debt distress and one is classified as being at moderate risk of debt distress.[18]

47. As the HIPC initiative winds down, questions arise as to how the debt problems of HIPCs and low-income countries will be addressed in the future. Ideally, solutions to these problems would arise in a transparent and speedy manner but this has generally not been the case. This situation calls for deeper solutions to be found at the international level to effectively remedy future debt sustainability problems.

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[15] See IMF, "Update on the financing of the Fund's concessional assistance and debt relief to low-income member countries", 30 April 2012, section V. A.

[16] These three countries had previously indicated that they did not wish to avail themselves of HIPC assistance, although Kyrgyzstan had recently expressed interest in MDRI assistance.

[17] IDA and IMF, "Heavily indebted poor countries (HIPC) initiative and the multilateral debt relief initiative (MDRI) — status of implementation and proposals for the future of the HIPC initiative", November 2011, see annex IV, table 1.

[18] See www.imf.org/external/pubs/ft/dsa/dsalist.pdf as of June 2012 and the joint IDA and IMF document, "Enhanced initiative for heavily indebted poor countries (HIPC) completion point document and multilateral debt relief initiative (MDRI)" for Côte d'Ivoire, appendix 3, available from www.imf.org/external/pubs/ft/scr/2012/cr12170.pdf.

Official development assistance

48. Official development assistance (ODA) flows constitute an important source of financing for developing countries to pursue the objectives outlined under the Millennium Development Goals and other internationally agreed development goals. ODA can also help developing countries to weather the negative effects that the global economic and financial crisis has had on trade, investment, remittances, exchange rate volatility and capital flows.

49. In recognizing the importance of ODA flows, the members of the international community have repeatedly come together to voice their support and agreement to provide and to progressively increase ODA to developing countries up to 0.7 per cent of the GNI of donor countries. The first such commitment was made by the General Assembly in 1970: resolution 2626 (XXV) set the agreed target for advanced economies to deliver a minimum of 0.7 per cent of GNI as ODA to developing countries. More recently, donors reaffirmed their commitment to increase aid flows in the Monterrey Consensus of the International Conference on Financing for Development of 2002 and reiterated their determination to ensure the timely and full realization of the development goals and objectives in the 2005 World Summit Outcome (see resolution 60/1). In the same year, members of the Group of Eight committed to increasing assistance to developing countries in the Gleneagles communiqué. Thus far, only five donor countries on the OECD Development Assistance Committee have reached or surpassed the target. In 2011, total Development Assistance Committee aid still stood at 0.3 per cent of total donor GNI, with the majority of countries still far from the 0.7 per cent target.

50. In 2011, ODA to developing countries from Development Assistance Committee donors decreased by 3 per cent with respect to its 2010 level and total net ODA, excluding debt relief grants and humanitarian aid, decreased by 4.5 per cent in real terms. This outcome, which marks the first decline in ODA, excluding debt relief, in more than a decade, reflects the impact of the global recession on donor aid budgets. The uncertain global economic outlook is likely to continue to affect aid budgets, thus raising concerns about the predictability of planned aid in the years to come.[19] The OECD survey on the forward spending plans of donors for 2012-2015 forecasts that ODA is likely to stagnate in the years after 2013, despite an anticipated rebound in aid in 2012. The report further emphasizes that population growth is likely to outpace aid. This would reduce country programmable aid per capita to 2005 levels for all regions except Africa.[20]

51. The emergence of new non-Development Assistance Committee donors presents new opportunities but also challenges. Scarce data, differing reporting methods and contrasting data definitions complicate donor coordination and render measurement of aid effectiveness difficult. Greater communication, reporting, cooperation and

[19] Research found that banking and financial crises in donor countries have a particularly large impact on aid flows. See Hai-Anh Dang, Steve Knack and Halsey Rogers, "International aid and financial crises in donor countries", policy research working paper 5162 (Washington, D.C., World Bank, 2009).

[20] See www.oecd.org/dataoecd/32/51/45564447.pdf.